

PORTFOLIO REBALANCING IN A BULL MARKET'S EXTRA INNINGS

by Mark Bentley, Executive Vice President, BTS Asset Management



*A 60/40 portfolio in
2009 could be an
84/16 portfolio today.*



*How to approach imbalances when
clients are worried about missing out on
performance?*

Find Opportunity



PORTFOLIO REBALANCING IN A BULL MARKET'S EXTRA INNINGS

A goal of asset allocation is to reduce risk through diversification across investments that perform differently during various market conditions. Two core asset classes used in a portfolio are stocks and bonds, with the classic “60/40” stocks/bonds portfolio serving as the benchmark in many portfolios.

Because asset allocation is necessarily dependent on individual goals, risk tolerance and investment time horizon, any significant variation from an agreed-upon risk profile needs addressing as part of an advisor’s fiduciary responsibilities.

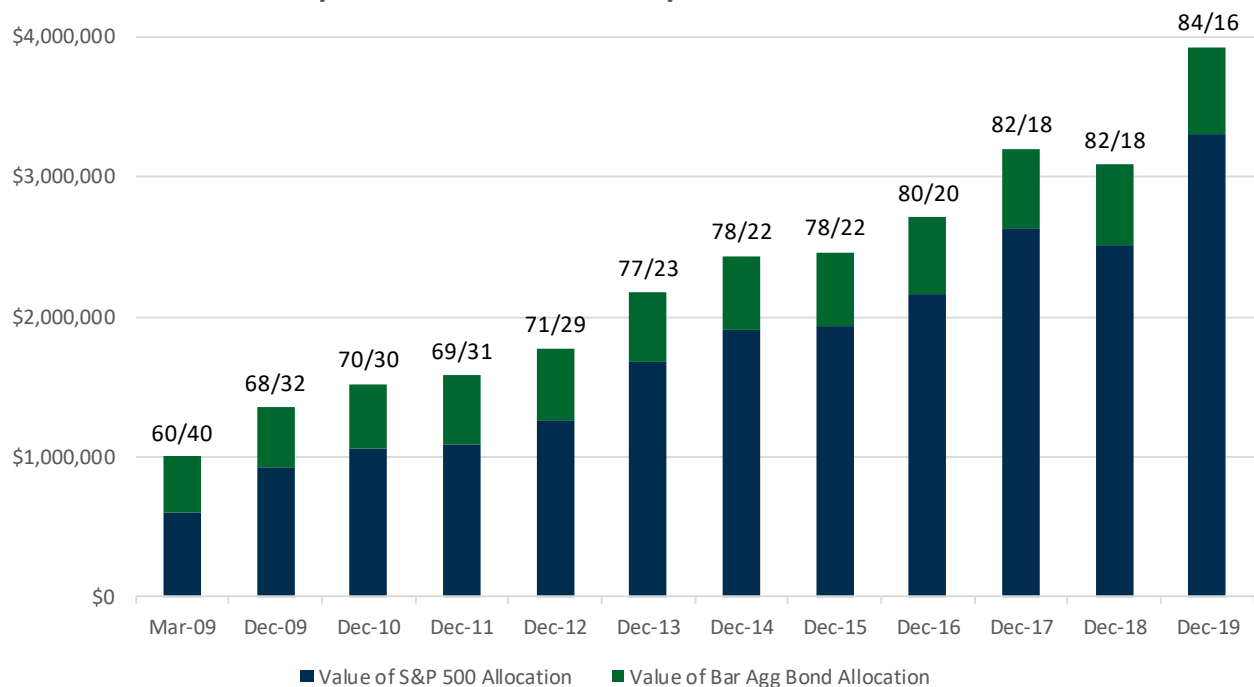
But what happens when clients are reluctant about rebalancing—as they may be during a long bull market in stocks, if worried about missing out on gains? That’s a challenge familiar to many advisors in what’s now the longest bull market on record.

In this paper, we’ll share our perspective on the need for rebalancing, how advisors deliver value in doing so, and why we believe the bond portion of many portfolios may be hiding greater risk than many investors realize.

The need for rebalancing

Consider a hypothetical \$1 million portfolio initiated at the start of the current bull market in stocks, allocated 60% to the S&P 500 Index and 40% to the Barclays Aggregate Bond Index. As the chart below illustrates, absent rebalancing, the portfolio would have quickly veered far from the investor’s original risk profile—all the way from 60/40 to 84/16.

Without rebalancing, this hypothetical \$1 million portfolio shifted from
60/40 in March 2009 to 84/16 in December 2019



For illustrative purposes only. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses. Past performance is no guarantee of future results.

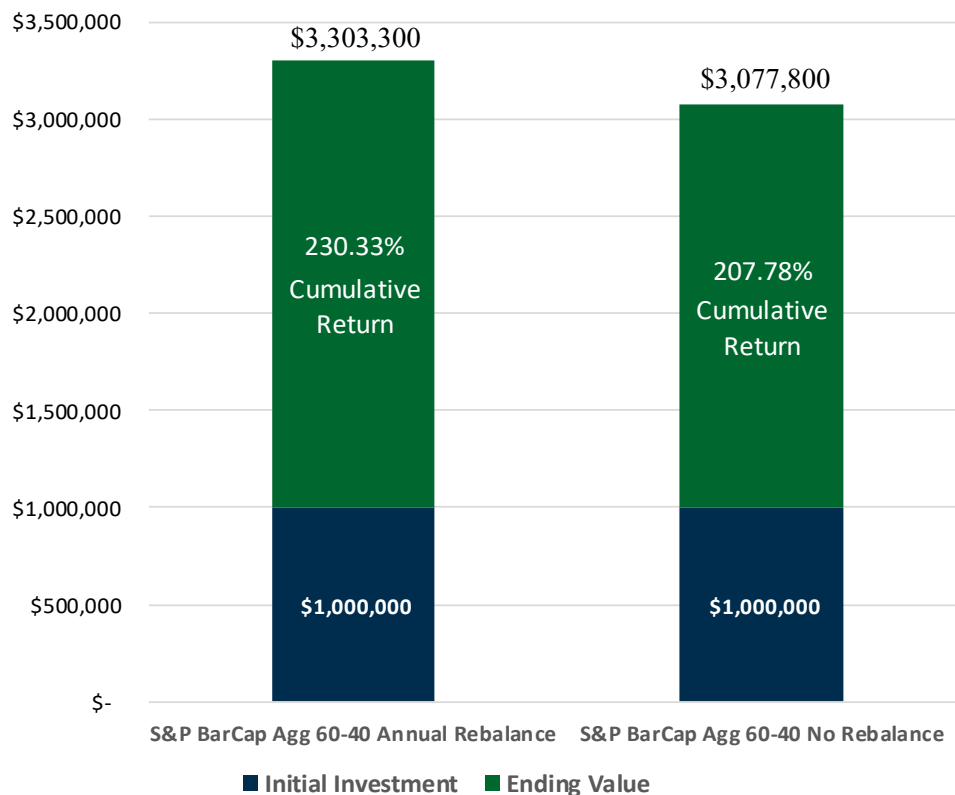
To many clients, rebalancing may seem counterintuitive because you are selling assets that have performed well and buying assets that have performed worse. During a long-trending bull market, a regularly rebalanced portfolio will generally underperform a non-rebalanced portfolio—thus the potential for concern about missing out on returns.

Besides the fear of missing out, there are also costs involved. Rebalancing entails costs such as transactions costs, capital gains realizations and potential performance drags.

On the positive side, rebalancing helps investors to lock in profits and purchase assets with lower relative valuations. Furthermore, no bull market lasts forever. In a mean-reverting market, rebalancing may increase risk-adjusted return. Most importantly—and critically for anyone charged with a fiduciary duty—rebalancing is vital to maintaining a risk profile.

Benefits of portfolio rebalancing - 1/1/2000 to 6/30/2020

Over a longer market cycle that includes bull markets and bear markets, rebalancing has reduced risk and increased return. For example, the following chart and return risk statistics are for a hypothetical 60/40 portfolio over the period January 1, 2000 to June 30, 2020. The annually rebalanced portfolio generated a cumulative gain of 230.33%, whereas the non-rebalanced portfolio gained 207.78%.



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Return & Risk Analysis, 1/1/2000 Through 6/30/2020

	S&P BarCap Agg 60-40 Annual Rebalance	S&P BarCap Agg 60-40 No Rebalance
Cumulative Return	230.33%	207.78%
Annualized Return	6.00%	5.64%
Standard Deviation	8.75	10.63
Sharpe Ratio	0.51	0.41
Downside Deviation	6.79	8.37
Sortino Ratio	0.75	0.58
Max Drawdown	-30.75	-35.99
Months to Recover	22	24

Past performance is no guarantee of future results.

Did the investor sign up for this level of risk?

It is crucial for investors to understand that rebalancing is about risk adjustment, not returns chasing. Investors may be concerned that rebalancing will lower performance, *but the reality is that the investor never signed up for the level of risk represented by a non-rebalanced portfolio.*

One of the most important pieces of portfolio management that an advisor can do for clients is maintaining the agreed-upon target weights and risk profile. Of course, if a client's risk tolerance has *increased*, then rebalancing during a bull market may not be warranted. But if the risk tolerance has stayed the same, we suspect most advisors would agree that their fiduciary responsibility calls for that tolerance to be heeded.

Programmatic rebalancing is a common approach that helps avoid reluctance to needed portfolio shifts:

- ⊙ In *periodic rebalancing*, the target allocation is rebalanced on a regular basis (monthly, quarterly, or annually).
- ⊙ In *percentage threshold rebalancing*, changes are triggered when any asset class deviates beyond a predetermined percentage level (for example +/- 5%) relative to the original portfolio allocation percentages.

Because of tax consequences and, historically speaking, there is little difference over the long run from monthly vs. quarterly vs. annual rebalancing, a reasonable balance between risk control and tax costs may be obtained through an annual rebalancing performed at a percentage threshold of +/- 5%.

The “same old allocation” may no longer match the risk profile

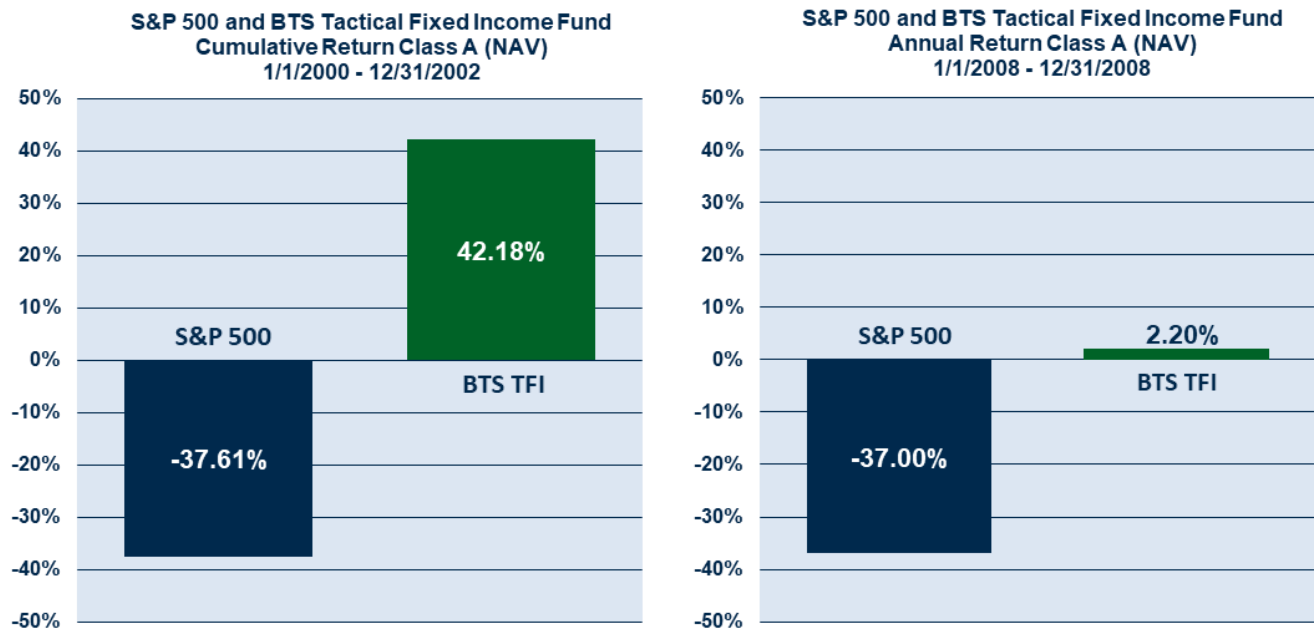
Rebalancing doesn't necessarily mean going back to the same old allocation. Instead, rebalancing should be seen as a point to consider reallocating among asset classes that may provide better opportunities. Market leadership changes over time, across asset classes and sectors, and investors need to be prepared to adjust.

A rebalancing program creates a level of discipline that may allow for opportunistic investing—for the purpose of maintaining the appropriate risk profile.

For example, many advisors realize that we are currently experiencing a unique risk setting with respect to the bond market. With the potential for unfavorable markets, a benchmark-centric or indexed-based bond allocation within a classic 60/40 portfolio might not be consistent with the investor's risk profile.

Bonds have enjoyed a remarkable 30-year bull market. However, we believe they must now be considered generally riskier due to potential unfavorable markets in the future. With that outlook in mind, it may be important to choose a tactical fixed income manager who has previously navigated unfavorable markets. The chart below outlines our own experiences unfavorable markets.

BTS Tactical Fixed Income Fund During Unfavorable Markets



Unfavorable Markets represented by annual and cumulative negative returns of the S&P 500 greater than negative 5%.

The performance data quoted here represents past performance. Current performance may be lower or higher than the performance data quoted above. Investment return and principal value will fluctuate, so that shares, when redeemed, may be worth more or less than their original cost. Past performance is no guarantee of future results. A Fund's performance, especially for very short periods of time, should not be the sole factor in making your investment decisions. For performance information current to the most recent month-end, please call toll-free 1-877-287-9820.

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Different bonds react differently during economic changes

Just as many equities (e.g. growth, value, large, small domestic and international) and commodities (e.g. agricultural, minerals, energy, and gold) react differently to economic stimuli, bonds, too, are not alike. Each bond class reacts in its own way to stimuli.

For example, interest rate changes are the primary, though not the only, factor affecting values of highly rated bonds, such as Treasuries bonds and Investment Grade Corporate bonds. The values of lower-rated bond classes, on the other hand, may be significantly affected by business factors, and less so by interest rate changes. For a few bond asset classes interest rates are not the major risk—in High Yields, for example, default risk has been more important to historical performance.

The sometimes-negative correlation between High Yield bonds and Treasury bonds, for example, supports our “right bond at the right time” philosophy, in our view. We designed the BTS Tactical Income strategy to try to take advantage of these relationships; by investing 100% in a chosen asset class rather than hugging a benchmark. It’s also critical to keep in mind the key risk characteristics of various bond asset classes—not just the volatility of each. Interest rate risk and default risk are two vital characteristics that vary widely across bond asset classes.

These correlation and risk characteristics potentially support the idea that regardless of the general direction of the market, many bond sectors perform differently from each other—possibly exposing opportunities.

10-Year Correlations as of 6/30/2020

Benchmark	High Yield ¹	Treasury ²	S&P 500 ³
High Yield ¹	1.00	-0.24	0.77
Treasury ²		1.00	-0.45
S&P 500 ³			1.00

¹BofAML US HY Master II TR USD | ²CITI Treasury Benchmark 10-Year USD | ³S&P 500 TR USD

Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses, or sales changes. Past performance is no guarantee of future results.

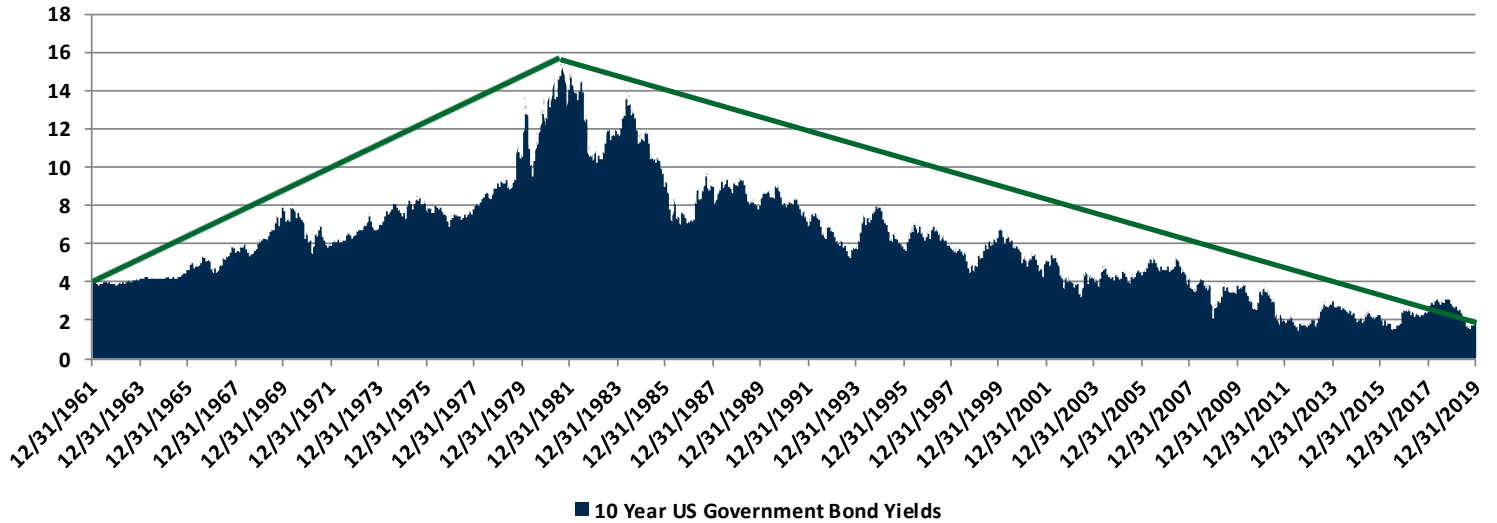
Different Bonds Have Different Risk Characteristics

Bond Sector	Interest Rate Risk	Default Risk
10 - Year U.S. Treasury	High	None
Municipal	High	Low
Investment Grade Corporate	High	Low
High Yield	Low	High

It's never a straight line

Looking at the past 30+ years of declining rates there have been numerous periods where rates actually went up (see chart below). During these periods investors could have taken the opportunity to look for other investments that may have been giving positive returns.

10-Year U.S. Government Bond Yields



	% Change 10 Year U.S. Government Yield ¹	IA Barclays U.S. H.Y. Corporate Bond Index ²	Barclays U.S. Government Index TR ²
Oct 93-Nov 94	45.34%	-0.05%	-4.65%
Oct 98-Jan 00	45.75%	6.30%	-1.85%
Jun 03-Jun 06	68.14%	28.18%	3.98%
Dec 08-Jun 09	73.43%	30.43%	-3.17%

Source: ¹Bloomberg | ²Morningstar

Source: Bloomberg

Furthermore, there have been periods of interest rate increases during which Treasuries and High Yield have performed in stark contrast to each other. In the four periods highlighted below there are stark differences in two fixed income asset classes. High Yields were able to give positive returns in three out of four periods, while Treasuries lost three out of four. These two asset classes act very different and may give potential upside opportunity for investors.

Fund Performance

Average Annualized Total Returns as of 6/30/2020	YTD ²	1 Year	3 Years	5 Years	10 Years	Since Inception 1/1/2000
Class A ¹ (NAV)	1.33%	1.86%	-0.52%	2.39%	2.86%	7.73%
Class A (Max. 5% Load)	-3.75%	-3.20%	-2.20%	1.34%	2.33%	7.46%
Class C	0.96%	1.09%	-1.24%	1.64%	N/A	1.30%
Class I (Inception 5/28/15)	1.40%	2.07%	-0.27%	2.65%	N/A	2.30%
Class R (Inception 5/5/15)	1.18%	1.47%	-0.78%	2.14%	N/A	1.80%
BBgBarc Agg Bond Index	6.14%	8.74%	5.32%	4.30%	3.82%	5.21%
Nontraditional Bond	-5.12%	-0.44%	1.37%	1.84%	2.04%	3.05%
S&P 500 BBgBarc Agg 50-50	5.13%	9.40%	8.63%	7.91%	9.16%	5.93%

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Total Expense Ratios: Class A: 1.91%; Class C: 2.66%; Class I: 1.66%; Class R: 2.16%

¹The BTS Tactical Fixed Income Fund does not have performance as a mutual fund prior to May 31, 2013. Performance prior to May 31, 2013 shown above is for the Fund's predecessor limited liability company (BTS Tactical Fixed Income Fund LLC, formerly known as BTS Asset Allocation/High Yield Fund LLC). The prior performance is net of management fees and other expenses. The predecessor limited liability company had been managed in the same style and by the same portfolio manager since the predecessor limited liability company's inception on January 1, 2000. The Fund's investment goals, policies, guidelines and restrictions are, in all material respects, equivalent to the predecessor limited liability company's investment goals, policies, guidelines and restrictions. The following information shows the predecessor limited liability company's annual returns and long-term performance reflecting the actual fees and expenses that were charged when the Fund was a limited liability company. From its inception on January 1, 2000 through the date of the prospectus, the predecessor limited liability company was not subject to certain investment restrictions, diversification requirements and other restrictions of the 1940 Act, which if they had been applicable, might have adversely affected its performance. In addition, the predecessor limited liability company was not subject to sales loads that would have adversely affected performance. The predecessor limited liability company's past performance is not necessarily an indication of how the BTS Tactical Fixed Income Fund will perform in the future.

²Performance for periods less than one year are not annualized.

There is no assurance that the Fund will achieve its investment objective. Investors cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Citi Treasury Benchmark 10 Yr tracks the 10 Year Treasury. 10 Year Treasury is Citi Treasury Benchmark 10-year USD. Nontraditional Bond category contains funds that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe. Many funds in this group describe themselves as "absolute return" portfolios, which seek to avoid losses and produce returns uncorrelated with the overall bond market; they employ a variety of methods to achieve those aims. Another large subset are self-described "unconstrained" portfolios that have more flexibility to invest tactically across a wide swath of individual sectors, including high-yield and foreign debt, and typically with very large allocations. Funds in the latter group typically have broad freedom to manage interest-rate sensitivity, but attempt to tactically manage those exposures in order to minimize volatility. The category is also home to a subset of portfolios that attempt to minimize volatility by maintaining short or ultra-short duration portfolios, but explicitly court significant credit and foreign bond market risk in order to generate high returns. Funds within this category often will use credit default swaps and other fixed income derivatives to a significant level within their portfolios. Municipals: Barclays Capital 10-Year Municipal Bond Index is comprised of investment grade tax-exempt bonds with maturities between eight and twelve years. High Yield: a Barclays U.S. H.Y. Corporate Bond Index is an index of USD-denominated, high yield, fixed-rate corporate bond market. BofAML US HY II TR USD: The Merrill Lynch US High Yield Master II Index is an index of high yield corporate bonds designed to measure the broad high yield market.

Corporate Bond portfolios concentrate on bonds issued by corporations. These tend to have more credit risk than government or agency-backed bonds. These portfolios hold more than 65% of their assets in corporate bonds, hold less than 40% of their assets in foreign bonds, less than 35% in high yield bonds, and have an effective duration of more than 75% of the Morningstar Core Bond Index.

S&P 500 includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. BBgBarc Agg Bond Index refers to the Bloomberg Barclays Aggregate Bond Index, which is comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities with maturities of one year or more to simulate the universe of bonds in the market. S&P 500 BBgBarc Agg 50-50 is a blended benchmark made up of 50% S&P 500 TR and 50% Bloomberg Barclays Aggregate Bond Index and uses indexes to represent a stock/bond allocation that a conservative or moderate investor might have.

Standard Deviation measures the degree of variation of returns around the average return; the higher the volatility, the higher the standard deviation. Sharpe Ratio is a risk-adjusted performance measure (the incremental average return over the risk-free rate - represented as 3% - divided by risk), where risk is defined by standard deviation. A higher Sharpe ratio may indicate higher risk-adjusted returns. Sortino Ratio is a risk-adjusted performance measure (the incremental average return over the minimum acceptable return - represented as 0% - divided by risk), where risk is defined by downside deviation. A higher Sortino Ratio may indicate higher risk-adjusted returns. Downside Deviation considers returns that fall below the minimum acceptable return. 0% is used for the minimum acceptable return.

Maximum Drawdown is the largest percentage drawdown that the investment has experienced.

Mutual funds involve risk, including possible loss of principal.

Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses, or sales charges.

The use of Credit Default Swaps involves investment techniques and risks different from those associated with ordinary portfolio security transactions, such as potentially heightened counterparty, concentration and exposure risks. There is a risk that issuers and counterparties will not make payments on securities and other investments held by the Fund, resulting in losses to the Fund. The Fund may invest in derivatives. Even a small investment in options may give rise to leverage risk, and can have a significant impact on the Fund's performance. Derivatives are subject to credit risk and liquidity risk. The values of foreign investments may be affected by changes in exchange control regulations, application of foreign tax laws changes in governmental administration or economic or monetary policy or changed circumstances in dealings between nations. In addition to the risks generally associated with investing in securities of foreign companies, countries with emerging markets also may have relatively unstable governments, social and legal systems that do not protect shareholders, economies based on only a few industries, and securities markets that trade a small number of issues. The Fund invests in fixed income securities, derivatives on fixed income securities or Underlying Funds that invest in fixed income securities.

The value of the Fund will fluctuate with changes in interest rates. Defaults by fixed income issuers in which the Fund invests could also harm performance. Lower-quality bonds known as "high yield" or "junk" bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds and reduce the Fund's ability to sell its bonds. The lack of a liquid market for these bonds could decrease the Fund's share price. The use of leverage by the Fund or an Underlying Fund will indirectly cause the Fund to incur additional expenses and magnify the Fund's gains or losses. The Fund may engage in short selling activities which are significantly different from the investment activities commonly associated with conservative fixed income funds. Underlying Funds are subject to investment advisory and other expenses, which will be indirectly paid by the Fund. As a result, your cost of investing in the Fund will be higher than the cost of investing directly in the Underlying Funds.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the BTS Tactical Fixed Income Fund. This and other information about the Fund is contained in the prospectus and should be read carefully before investing. The prospectus can be obtained on our web site, www.btsfunds.com, by calling toll free 1-877-287-9820 (1-877-BTS-9820), or by calling your financial representative. The BTS Tactical Fixed Income Fund is distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. BTS Asset Management, Inc. is not affiliated with Northern Lights Distributors, LLC.

About BTS Asset Management

BTS Asset Management (BTS) serves as the investment advisor to the fund. Founded in 1979, BTS Asset Management is one of the oldest nontraditional risk managers, managing traditional assets with a nontraditional approach.

- ◆ The Fund seeks to provide total return.



FIND OPPORTUNITY

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